IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

No. 354

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

against

ELLIOTT H. WHEELER and ROLLO C. WHEELER, EXECUTORS OF THE ESTATE OF JOHN H. WHEELER, DECEASED, *et al.*,
Respondents.

ON WRIT OF CERTIORARI
TO THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR RESPONDENTS

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OPINIONS BELOW

The opinion of Judge Arnold of the Tax Court is reported at 1 T. C. 640 (R. 57-81). The opinion of Judge Garrecht for the Circuit Court of Appeals of the Ninth Circuit, reversing the Tax Court, is reported at 143 F. (2d) 162 (R. 121-130).

JURISDICTION

The jurisdiction of this Court is invoked under § 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (43 Stat. 938, 28 U. S. C. § 347(a)). The judg-

ment of the Circuit Code of Appeals was entered on May 16, 1944 (R. 130), the several cases having been consolidated for purposes of review in that Court by its order dated August 24, 1943 (R. 114). Petition for writ of certiorari was filed on August 16, 1944, and was granted on October 16, 1944 (R. 131).

QUESTIONS PRESENTED

1. The ultimate question in this case is the following: When a corporation sells property at less than such property cost it, does it have "earnings and profits" from such sale in the sense in which that term is used in the Federal revenue laws,

(a) under the Revenue Act of 1938,

(b) under § 501 of the Second Revenue Act of 1940?

2. Is § 501 of the Second Revenue Act of 1940 in terms or intent retroactive for the purpose of affecting income tax liability for 1938?

3. If § 501 of the Second Revenue Act of 1940, enacted October 8, 1940, is retroactive so as substantially to increase the income tax of the respondents for 1938, does such application deprive the respondents of property without due process of law, within the meaning of the Fifth Amendment to the Constitution of the United States?

If question 1 (both (a) and (b)) be answered in the negative, consideration of questions 2 and 3 will be unnecessary. If question 2 be answered in the negative, consideration of question 3 will be unnecessary.

THE STATUTE

These cases are controlled by the Revenue Act of 1938 (52 Stat. 447). The provision directly applicable is § 112(b)(7)(E)(i). Also pertinent are or may be § 112(b), subdivision (5) and the balance of (7); § 113(a), subdivisions (6) and (8); § 115, subdivisions (a) and (c); and § 117, subdivisions (a), (b) and (c). The Commissioner also claims that § 501 of the Second Revenue Act of 1940 is relevant. All the above sections except § 113(a)(6) and § 117, subdivisions (a), (b) and (c) are set forth in Appendix A to the Commissioner's brief. The last-named sections are set forth in Appendix I to this brief. Excerpts from the Congressional Committee Reports with respect to § 501, above-mentioned, are set forth in Appendix A to the Commissioner's brief. Sections 112(b)(7) and 501 are also set out in the Record (R. 61, 66).

STATEMENT OF THE CASE.

(1) OUTLINE OF THE ISSUES.

The case involves income tax for the year 1938 *i.e.* whether the shareholders of a corporation received a taxable distribution in December, 1938 from its "earnings and profits".

It is stipulated that, under principles of accounting and of corporation law, the corporation in question had no accumulated undivided profits and surplus, but rather a capital deficit (R. 33). The corporation not merely had no earnings and profits according to principles of accounting and corporation law; so far as here material, it had not *realized* any capital gain.

It is further stipulated that the liquidation here was carried out in contemplation of a statutory provision expressly applicable thereto (R. 37).

Said statutory provision was § 112(b)(7) of the Revenue Act of 1938, which provided that upon a complete liquidation of a corporation in December 1938, the shareholders might elect not to be taxed upon their own capital gain, but to be taxed as a dividend upon their pro rata share of the earnings and profits of the corporation (inclusive, of course, of any capital gain actually realized by the corporation itself and therefore included in its earnings and profits).

The problem presented in the case is therefore whether there is any applicable provision of statute or regulation under which, contrary to the language of § 112(b)(7), the corporate deficit must be deemed to have been converted into a corporate surplus.

The Commissioner issued his deficiency letter, not upon the theory that this result was reached by the applicable 1938 Act itself or any regulation under it, but upon the theory that, by retroactive amendment, § 501(a) of the Second Revenue Act of 1940 was applicable (R. 13).

Both Courts below held that this was so, and the Circuit Court of Appeals for the Ninth Circuit thereupon held that such retroactive application was unconstitutional. The Commissioner now argues alternatively that the 1940 Act need not to be considered, and that a sentence out of Treasury Regulations 101 (art. 115-3), in effect in 1938, should be construed to have itself required the conversion of deficit into surplus.

(2) RESPONDENTS' POSITION.

1. That the express provisions of the Revenue Act of 1938, pursuant to (and in admitted conformity with) the terms of which respondents carried out this transaction, indisputably provide that respondents are not to be taxed as a dividend in respect of an amount of a taxable gain by the corporation exceeding the corporation's actual earnings and profits.

2. That the meaning of the statute was not altered by the regulation (Art. 115-3 of Reg. 101) that gains within the purview of § 112 are brought into earnings and profits to the extent recognized under the statute.

3. That § 501(a) of the Second Revenue Act of 1940 is not applicable to the facts of this case since it applies only to gains *realized* by a corporation.

4. That in any event the provisions of the 1940 Act were prospective only and not retroactively amendatory of the 1938 Act.

5. That if the provisions of the 1940 Act were retroactively amendatory of the 1938 Act, it was because of a provision of the 1940 Act which was stated to be effective in respect of *all* former revenue acts, and which under the facts in this case would have to be applied (so as to increase the tax of the respondents) to a provision two years earlier which had specifically provided the nature and amount of tax to be levied upon the particular transaction, and that under such circumstances its application would be unconstitutional.

(3) THE FACTS AS TO THE LIQUIDATION IN 1938.

The facts were stipulated (R. 30-39):

The John H. Wheeler Company was a California corporation. During the years 1925 to 1929 it issued its par value capital stock of $491,800 for property worth that amount (R. 32). From 1931 to 1937 it sold most of such property for less than cost (R. 17-18) and thus incurred a capital deficit. As of December 1938 its capital deficit was $47,501.61.

On May 27, 1938, Congress enacted § 112(b)(7), in effect inviting liquidations of corporations to take place in December 1938 upon the basis that an individual shareholder might then elect not to be taxed upon the capital gain, but only to be taxed, as on a dividend, on

> "so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated * * *".

On this basis, as the corporation had a deficit, Mr Wheeler would have no further tax to pay; and the same would of course be true of the other respondents.

It is stipulated that it was

> "After giving consideration to the application of Section 112(b)(7) of the Revenue Act of 1938" (R. 34)

that the stockholders dissolved the corporation on December 2, 1938, and that the respondents exercised the election to be taxed for 1938 under that statute. The Treasury Regulations provide that such election cannot be withdrawn or revoked. Article 112(b)(7)-2 of Treasury Regulations 101. It is stipulated that no claim is made by the Commissioner that the proceedings under § 112(b)(7) were defective or incomplete (R. 37).

The situation is not claimed to have been affected by the next three Revenue Acts, namely, the Internal Revenue Code, 53 Stat. Part 1, the Revenue Act of 1939, 53 Stat. 862, and the (First) Revenue Act of 1940, 54 Stat. 516.

(4) THE DEFICIENCY ASSESSMENT IN THIS CASE—PURPORTING TO APPLY THE 1940 STATUTE TO THE 1938 TRANSACTION.

In his deficiency letter in 1941, the Commissioner took the position that § 112(b)(7) of the 1938 Act had been so amended by the new § 501 of the Second Revenue Act of 1940 that the Company's earnings upon the sale of its properties at a loss from 1931 to 1937 should be based on what the Company's transferors paid for the property rather than on the Company's cost of the property (R. 12-13).

The cost to the transferors to the Company of the properties had been $304,684.49. That was the basis the law required the Company to use in computing its own income tax on the sale of the properties from 1931 to 1937. § 113(a)(8). (R. 33).

If corporate earnings were to be calculated on transferor's cost, they would have amounted to $126,860.32:

Corporation's cost	$491,800.00
Transferors' cost	304,684.49
	$187,115.51
Adjustments not involved in the case.	6,800.52
	$180,314.99
Actual corporate deficit	47,501.61
Earnings determined by Commissioner	$132,813.38
Less Tax Court reduction . . .	5,953.06
	$126,860.32

At the effective capital gains rate of 15% which would have been applicable if the shareholders of the Company had not elected to come under § 112(b)(7), (see § 115(c) and § 117(b) and (c)(1)), the tax for example on the shareholder John H. Wheeler[1] would have been about $23,825 upon the complete liquidation of the Company in December, 1938:

Fair market value of property received by him in liquidation (R. 34)....	$312,335.92
Basis of his stock..................	153,505.01
A gain of...................	$158,830.91
½ of gain....................	$ 79,415.46
Tax at 30%..................	$ 23,824.64

Had it been liquidated under § 115(c), the tax to John H. Wheeler would therefore have been considerably less than under the assessment actually made on the application by the Commissioner of the 1940 Act to § 112(b)(7). The deficiency determined by the Tax Court was $28,123.46 (normal tax of 4% and progressive surtax running up to 55% applied to $63,430.16, his share of the "earnings"). The Commissioner's brief is in error in saying the contrary (at pp. 39, 42 and fn 29); the source of the error is evidently in the Commissioner's overlooking the 15% rate (30% on one-half the gain) under § 117(c)(1) where (as here) the shares had been held for more than 24 months.

[1]John H. Wheeler, whose estate is one of the respondents, owned 50% of the shares. The four other respondents each owned 10%.

In liquidating under § 115(c), moreover, the shareholder would have had the tax basis for the assets received on liquidation increased by the full amount of his gain, namely, $158,830.91. Under § 112(b)(7), on the Commissioner's theory, his tax basis would have been increased by only $63,430.16, his share of the "earnings" (§ 113(a)(18)) and he would have had to pay another tax on a gain of almost $90,000 had he made an immediate resale of the assets.

There is no finding, and no evidence that the corporation *would have been* liquidated under these conditions at all. *Certainly*, it would not have been liquidated under § 112(b)(7).

And there is no suggestion that the corporation was being used to avoid surtax on current income, or that its stockholders were afraid of penalty therefor. Its regular practice had been to pay its entire income to its stockholders in annual dividends (R. 18).

To summarize, and using the shareholder John H. Wheeler as an example: As the law was in 1938, by electing to come under § 112(b)(7), the liquidation of the Company was substantially tax-free; but if the Company had been liquidated under § 115(c)—the provision ordinarily applicable to liquidations—the tax would have been $23,824.64. Under those circumstances, § 112(b)(7) was obviously the preferable provision to elect. On the Commissioner's construction of § 501 of the 1940 Act, however, the tax under § 112(b)(7) is $28,123.46 (with an increase in tax basis of only $63,430.16), as opposed to the tax of $23,824.64 under § 115(c) (with an increase in tax basis of $158,830.91). Under *those* circum-

stances, § 115(c) would have been the preferable section to elect.[2]

(5) CIRCUMSTANCES UNDER WHICH § 501 OF THE SECOND REVENUE ACT OF 1940 CAME TO BE ENACTED.

A series of events relating to gains realized by a corporation (and therefore unlike this case, in which the corporation never realized a gain) gave rise to § 501 (a) of the Second Revenue Act of 1940.

On March 27, 1939, the Third Circuit Court of Appeals, in an opinion by Circuit Judge Davis (concurred in by Judges Buffington and Maris) held, in *Commissioner* v. *F. J. Young Corporation*, 103 F. (2d) 137, that a *realized* gain in a tax-free corporate reorganization became a part of earnings and profits at once and before it was *recognized* for income tax purposes under § 112 of the Revenue Act of 1928. The circumstances were later summarized by House Report 2894, 76th Cong., 3d Sess. as follows:

> For example, on January 1, 1930, the X Corporation owned stock in the Y Corporation which it had acquired in 1929 in a transaction wherein no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was $100. The fair market value of the stock in the Y Corporation received by the X Corporation was $1,000. On

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[2] Section 112(b)(7), of course, had application only to the tax of the *shareholders* upon a corporate liquidation. In no event does a corporation realize any gain or loss upon the distribution of its assets in kind in complete liquidation. Article 22(a)-21 of Treasury Regulations 101.

April 9, 1930, the X Corporation declared a cash dividend of $900 and, except for the possible effect of the transaction in 1929, had no accumulated earnings or profits as of that date. Under the interpretation of the Board and some of the courts, the excess of the fair market value of the stock of the Y Corporation over the basis, $900, would represent earnings or profits, and the cash distribution would be a taxable dividend (*Commissioner* v. *F. J. Young Corporation*, 103 Fed. (2d), 137).

X corporation had *realized* a gain of $900 on the exchange of its property for the stock of Y Corporation (*Marr* v. *United States*, 268 U. S. 536). The Third Circuit Court of Appeals held that such realized capital gain or loss was to be brought into earnings and profits (with the incidental consequences upon the corporation's dividends), even though it had not yet become recognized because of the postponement provisions of § 112.

The House Report proposed legislation to overrule the *F. J. Young* case, saying that it was contrary to "the rule applied by the Treasury" (in Art. 115-3 of Treasury Regulations 101), in which "taxpayers generally have concurred", that

> "Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section."

The House Report concluded that this was the true view of the law and therefore recommended that it be enacted into statute.

The Senate Report was substantially to the same effect (S. Rep. 2114, 76th Cong. 3d Sess.); and the proposed legislation became a part of the Second Revenue Act of 1940 as § 501 (§ 115(l) of the Internal Revenue Code), the provision being (in part)

> "The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation * * * (2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain."
>
> "Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made."

The amendment thus applied, and only applied, to gain or loss *realized* from a sale or other disposition of property, as was indeed appropriate to its purpose of overruling *Commissioner v. F. J. Young Corporation* and of confirming a Treasury Regulation which had similar application.

Its purpose and effect was to confirm that when gains or losses have been realized, the time when and the extent to which they are brought into earnings and profits are governed by the provisions of § 112 for their recognition.

(6) HISTORY OF THIS LITIGATION.

Under this sub-heading, we are not discussing the merits, but merely outlining the various positions taken by

the Courts below and the parties. We think that such an approach may be helpful in this particular case, in which the ultimate issue has proven curiously elusive, as evidenced by the fact that both parties are here taking positions different from those taken by either Court below.

As this case necessarily involves several groups of concepts—"gain or loss", "realized", "recognized", "earnings and profits", and "dividends"—each of which has a long history of its own in income tax law, and as to each of which there are a number of provisions of statute and regulation which interplay, it is not surprising that although the Tax Court and the Circuit Court of Appeals decided the case on one issue, they disagreed in their conclusion, or that now both petitioner and respondents agree that the issue decided by the lower courts (a serious constitutional issue) can be avoided and the case be decided on other grounds.

Both Courts below assumed that the Second Revenue Act of 1940 retroactively governed this 1938 liquidation, so that the only question to be determined was its constitutionality. The Tax Court held it constitutional, and the Circuit Court of Appeals held it unconstitutional. Under these circumstances, the grant of a writ of certiorari naturally followed.

The petitioner argues here as his first point that the Courts below did not need to consider the 1940 amendment because the case should be governed in the petitioner's favor by Art. 115-3 of Treasury Regulations 101. That article had not been relied upon by the petitioner in his deficiency letter (R. 10-14).

As his second point, the petitioner supports the point that was assumed by both Courts below, viz. that the Second

Revenue Act of 1940 applies (if constitutional); and he then argues that it is constitutional.

We agree with the petitioner that the 1940 Act, the sole subject of analysis by the Courts below, need not have been considered. Thus the first point both of the petitioner and the respondents is that the case should properly be determined under the applicable 1938 Act itself.

Our first point is that the 1938 Act is plain on its face. The petitioner counters that there is ambiguity in the statutory phrase "earnings and profits of the corporation", and that resort must be had in its construction to the 1938 Regulation, Art. 115-3.

The respondents' replies are (1) That there is no ambiguity in the phrase "earnings and profits of the corporation", which is a long-standing phrase in the income tax acts, and (2) that in any event the Regulation is inapplicable.

The second parts of both briefs—petitioner's and respondents'—deal with the Act of 1940. The first question is whether the 1940 Act (whether prospective or retroactive) is applicable at all to the facts of this case. The next question is whether the 1940 Act is prospective in terms, or whether it retroactively applies to the 1938 Act. If it does not retroactively apply to the 1938 Act, the 1938 Act remains governing and the respondents prevail. If it does retroactively apply to amend the 1938 Act, the constitutional issue must then, but only then, be squarely faced.

SUMMARY OF ARGUMENT

PART ONE.

THE 1938 ACT.

The term "earnings and profits" has uniformly been held to be an accounting concept, defined by this Court in *Edwards* v. *Douglas*, 269 U. S. 204, to mean "undivided profits or surplus". The latter is a well-known accounting term. The Ways and Means Committee at the time of the 1940 Act agreed that the computation of earnings and profits "should be made conformably to the best accounting practice".

In applying the above principles, the cases have uniformly held that only *realized* gains could be taken into account in computing corporate earnings. That, plus the fact that "earnings and profits" is an accounting concept, excludes the possibility of using transferor's cost rather than corporate cost in computing corporate earnings. Accountants compute corporate earnings from the sale of property on what the corporation paid for the property—they are not interested in what the corporation's transferor paid for the property. If property cost the corporation's transferor $100,000 but cost the corporation $200,000 and was sold by the corporation for $150,000, every accountant would determine that the corporation had lost $50,000 on the transaction. The fact that the corporation (because it used transferor's basis for income tax purposes) had to pay an income tax of, say, $7,500 based upon a fictitious gain of $50,000, would be relevant in computing the earnings of the corporation only because earnings would be *further*

reduced by the $7,500 tax that had to be paid upon the transaction.

The Treasury Regulation relied on by the Commissioner has never been treated by any court as requiring the use of transferor's basis in computing earnings and profits.[7] The Regulation is applicable only to gains or losses "within the purview of § 112", i.e., gains or losses which have been realized but which because of the tax-free exchange provisions of § 112 are not recognized until a later date. That was the *F. J. Young Corporation* case. The Company in the instant case had no gains or losses within the purview of § 112. When it bought the property for its stock it made a purchase, not a sale. When it sold the property later at a loss, it realized no gain the recognition of which was postponed. It was merely required to take the low basis of its transferors for its own income tax purposes under § 113(a)(8).

We pass to the alternative source relied upon by the petitioner—§ 501 of the Revenue Act of 1940.

PART TWO.

THE 1940 ACT.

The Commissioner can derive no aid from § 501 since it is in terms applicable only to *realized* gains and losses. The Company could *realize* no gain by selling for less than cost. Before § 501 a court had held that mere realization was sufficient to have a gain taken into earnings. § 501 added the requirement of *recognition* (so that in cases where a recognition was postponed a gain would be taken into earnings at the later date when recognized). § 501 did

not subtract the requirement of *realization*. In fact, the section uses the word "realized" four times and is applicable only to "realized gains or losses".

It was assumed by both Courts below that the 1940 Act was retroactive. This appears to us to pay insufficient respect to the established doctrine that, in order to avoid grave constitutional questions, statutes are to be construed, wherever reasonably possible, as prospective. That doctrine has had particular application where Revenue Acts are concerned. As the 1940 Act, if retroactive, would amend (i) *all* prior Revenue Acts, and (ii) in this case an Act which was of specific application to liquidations "in December 1938" and was relied upon by these taxpayers in making an election offered by its terms, the presumption against retroactivity becomes particularly strong.

Finally, if the issue of constitutionality must be faced, it appears that if the Court is to hold this statute constitutional, it must go the full length of laying down a rule that no Revenue Act can be unconstitutional on the ground of retroactivity. This would overrule a line both of decisions and of *dicta* (appearing in opinions of the present Chief Justice, Mr. Justice Holmes, Mr. Justice Brandeis, Mr. Justice Roberts and Mr. Justice Cardozo), in which it has been recognized that retroactive revenue statutes may be unconstitutional if they exceed the bounds of what is "permissive". But this is the first case in which the Court has been confronted with a Revenue Act whose alleged retroactivity is applicable not merely to the earlier part of the same year or to the preceding year or indeed to any limited number of years, but to *all* of the years without limitation. And the earlier statute which on the facts of this particular

case is alleged to have been retroactively amended, is a specific statute which contained an "invitation" to the taxpayers to undertake this particular transaction "in reliance" upon it.

We are not, of course, arguing that the relation of the Congress to the taxpayer is susceptible to legal definition in terms of "invitation" and "reliance". These are merely used as apt words to identify the type of statute which admittedly the Congress had enacted in 1938, to-wit one in which it provided that particular legal consequences would attach to particular transactions (complete liquidations effected during the month of December 1938).

ARGUMENT

PART ONE

THE 1938 ACT

POINT I

UNDER THE LAW IN EFFECT IN 1938, THE COMPANY HAD NO EARNINGS AND PROFITS.

(1) THE 1938 ACT IN ITS TERMS SUPPORTS THE RESPONDENTS' POSITION.

This point does not seem to be seriously disputed by the petitioner and was assumed in respondents' favor by both Courts below. Otherwise, of course, no question of retroactive application of the 1940 Act could arise. Nor would there be need to appeal to any Regulation (as the Commissioner now does in his Point I).

The material provisions of the 1938 Act are:

> "Sec. 112 Recognition of Gain or Loss.
>
> "(b) *Exchanges Solely in Kind.*
>
> "(7) *Election as to recognition of gain in certain corporate liquidations.*
>
> "(E) *Non-corporate shareholders.*
>
> "(i) There shall be recognized [to the shareholder], and taxed as a dividend, so much of the gain [of the shareholder] as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913 * * *."

It is thus provided that:

(1) Some, but not all, of the "gain" is to be recognized.

(2) "The earnings and profits of the corporation" (not the taxable income of the corporation) determine the amount of the gain to be recognized to the shareholder on liquidation.

(3) The tax thereon to the shareholder is to be "as a dividend."

(2) HISTORY OF THE APPLICABLE TERMS OF THE 1938 ACT.

(a) "Earnings and Profits."

In 1938, the statute contained no definition of the term "earnings and profits" as used in § 115(a) (defining a dividend) or § 112(b)(7).[3] That term was not contained at all in the Revenue Act of 1913. It first appeared in the Revenue Act of 1916 (§ 2(2)). The Revenue Act of 1917 (§ 1211), in addition to the term "earnings or profits", also used the term "undivided profits or surplus". There is no distinction between the terms "undivided profits or surplus" and "earnings or profits." *Edwards v. Douglas*, 269 U. S. 204. *Mertens, Law of Federal Income Taxation*, Vol 1, § 9.03, p. 417, fn. 21.

It was stated with respect to the 1918 Act, and has since been universally accepted, that the Congress intended the use of the term "earnings and profits" in the ordinary accounting understanding. In *Commissioner v. James*, 49 F. (2d) 707 (1931) the Circuit Court of Appeals for the Second Circuit said, at p. 708:

[3]The term is used in the disjunctive in § 115(a) and in the conjunctive in § 112(b)(7), but no point is made of that difference. Both phraseologies are used interchangeably throughout this brief.

"In employing the phrase 'earnings and profits' in Section 201 [of the Revenue Act of 1918] we think Congress intended the use of the term in the ordinary accounting understanding * * *"

This was in accord with the general rule that terms used in the Revenue Acts, unless specially defined, are used in their ordinary, every day sense. *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, 370; *Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 327; *Old Colony Railroad Co.* v. *Commissioner*, 284 U. S. 552, 560; *Deputy* v. *du Pont*, 308 U. S. 488, 498.

So also at the time of the enactment of § 501 of the Second Revenue Act of 1940, the Ways and Means Committee stated that, consistently with the rules there laid down, it was contemplated that the computation of the earnings and profits "shall be made conformably to the best accounting practice." (Report No. 2894, 76th Cong. 3d Sess., p. 43).

The phrase "earnings and profits" in the Revenue Acts is uniformly used in contradistinction to the term "capital".

In the instant case the Company paid $491,800 by issuing its stock worth that amount for property worth that amount. The entire $491,800, the par amount of the stock issued, was set up on the Company's books as capital.[4]

[4] Under California law the full market value of the assets transferred became capital of the corporation. Capital stock was issued therefore in a par value equal to the amount thereof; and accordingly no part of it was surplus available for distribution to stockholders. Civil Code of California, §§ 290, 323. See e.g. as to the date of incorporation of the Wheeler Company (1925), *Kerr's Cyc. Codes of Calif.* (1920, Civ. Code Part One pp. 410 and 488; and Hillyer's Consol. Supp. thereto, 1921-1925). *Dominquez Land Corp.* v. *Daugherty*, (In Bank 1925) 196 Calif 468, 477; 238 Pac. 703, 706-7.

The transferors had paid less than $491,800 for the property; but the Company realized no "earnings and profits" from the transfer to it. The property was subscribed for in par value capital stock, and the Treasury Regulations have long provided that a corporation realizes no gain or loss on the original issue of its own stock. See Treasury Regulations 101, Article 22(a)-16.[5] By the same token a corporation could not realize earnings and profits by selling, for less than cost to the corporation, the property which it had acquired for its stock. From *Doyle* v. *Mitchell Brothers Company*, 247 U. S. 179, to date, it has been settled that a taxpayer must be allowed to get his cost back on the sale before he can be treated as realizing income; that the conversion of property into money without gain does not result in earnings. As this Court said in the *Mitchell Brothers* case, at p. 185:

> "Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the 'gross income' received 'from all sources;' and by applying to this the authorized deductions we arrive at 'net income.' In order to determine whether there has been gain or loss, and the amount of the gain if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

[5] "The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock."

Accordingly, the Company realized no earnings or profits on a sale at a loss.

In *Edwards* v. *Douglas*, 269 U. S. 204, *supra*, this Court defined the term "earnings or profits", as contained in the Revenue Act of 1917, as meaning "undivided profits or surplus." Faced with a statute which contained both terms, it held that they meant the same, reversing the Court below which had held to the contrary.

The Company in the instant case had no undivided profits or surplus (R. 33, 41, 43). Accordingly, the Company could have no "earnings or profits", as defined by this Court.

(b) "Realized" and "Recognized."

Realization of gain or loss is in large measure a factual concept; *recognition* of gain or loss is wholly a concept of the taxing act. As to realization, the first question always is: has the taxpayer in fact made or lost money on the sale? The question whether a gain shall be "recognized" for the purpose of the taxing act depends upon whether the taxpayer is to be taxed thereon at once or is not to be taxed thereon until some later occasion.

Under the Revenue Act of 1913, when income taxation was a comparatively simple matter, realization and recognition coincided. Because of decisions of this Court that gain or loss was "realized" in connection with certain corporate reorganizations (*Rockefeller* v. *U. S.*, 257 U. S. 176, *Cullinan* v. *Walker*, 262 U. S. 134, *Marr* v. *U. S.*, 268 U. S. 536), the Congress, in § 202(c) of the Revenue Act of 1921, 42 Stat. 227, followed by § 112 of the Revenue Act of 1928, 45 Stat. 791, and its successors, provided that

although such gain or loss was *realized*, it would not, in certain types of corporate reorganizations, be *recognized* for income tax purposes until a later date. Thus recognition was in certain cases postponed until *after* realization. A gain could be realized but not recognized.

The Congress then determined, in order to prevent avoidance of income tax, that in certain situations a corporation should be required, for the purpose of *recognition* of gain, to take the tax basis of its transferor. This was true in the case of transfers to controlled corporations, § 113(a)(8). The concept of *realization*, being a factual one, remained unaffected. A corporation might sell property at a loss and still be subject to income tax. See *Perthur Holding Corp.* v. *Commissioner*, 61 F. (2d) 785, discussed at page 26, *infra*.

(c) "Realized" and "Recognized" as Applied to "Earnings and Profits."

The cases dealing with earnings and profits have always held that no gain or loss can come into the earnings and profits of a corporation until it has been realized. We know of no case to the contrary. In other words, the only gains or losses which affect a corporation's earnings are actual gains or losses, i.e., those realized. The question of recognition, which was wholly an income tax concept, had no bearing upon a corporation's earnings.

For reasons of convenience, the Treasury in its Regulations has provided since 1934 (Treasury Regulations 86, Article 115-1) that a realized gain or loss should not be taken into the earnings or profits until it was recognized. At least one Circuit Court of Appeals decision refused to

follow that concept, *Commissioner* v. *F. J. Young Corp.*, 103 F. (2d) 137 (C. C. A. 3d, per Davis, J.), and accordingly the Congress enacted it into law in § 501 of the Second Revenue Act of 1940.

However, as will be shown more fully in Part Two of this brief, the Congress did not by § 501 abolish the concept that a gain or loss must be realized before it can enter into the computation of earnings. § 501 applies only to *realized* gains or losses; such indeed are its express terms.

What the Commissioner is attempting to do in this case, is to reverse his field and to claim that his Regulation and § 501 apply to *recognized* but *unrealized* gains or losses. A reading of his Regulation and of the section makes it apparent that they apply only to realized but *un*recognized gains or losses, i.e., gains or losses the recognition of which is postponed until a later date. The Commissioner's own brief supports the same conclusion, since he refers to the provisions directing the "*non*recognition of gain or loss", "gains and losses *not* recognized for the purpose of computing taxable income", etc. (pp. 17, 18 of the petitioner's brief).

(d) "Taxable Income."

It has been well settled for many years, both by Court decision and by Treasury Regulations and rulings, that the term "earnings or profits" is not the same as taxable income. See the cases and rulings cited and discussed in Appendix II to this brief, many of which were decided in the 1920s and early 1930s. The rule works both ways. Some items which are not taxable income increase earnings

and profits, and certain adjustments which do not reduce taxable income do reduce earnings and profits. Thus, earnings and profits may be either more or less than taxable income, depending on the circumstances. Both the Commissioner and taxpayers have relied on the rule where it was to their advantage to do so.[6]

The only reason that the Company, under § 113(a)(8), was required to compute its taxable income on a sale of its property by using the tax basis of its transferors, was that in a double check against possible avoidance of tax,[7] the Congress had provided that not only did the transferors retain their low tax basis on the shares which they received (§ 113(a)(6)), but also the Company had the same low tax basis in computing its taxable income on sale of the property which it acquired (§ 113(a)(8)). The Revenue Acts recognize a fictitious gain because the corporation is required to use a low basis for income tax purposes. The cases dealing with § 113(a)(8) make it clear that a corporation *realizes* no gain upon the sale of its property at a loss. In *Perthur Holding Corp.* v. *Com'r.*, 61 F. 2d 785 (C. C. A. 2d, 1932), cert. den. 288 U. S. 616, the Court said (pp. 785-6):

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[6]For instance that rule was applied three times by the Commissioner and the Tax Court in computing the Company's earnings and profits in this case. Earnings were increased $203,085.19 above taxable income by dividends which were not taxable income (R. 17-18); decreased by $27,553.18 of losses which were not allowable for income tax purposes (R. 18); and decreased by $5,953.06 of income taxes which were not deductible for income tax purposes (R. 81).

[7]The revenue is amply protected by taxing the shareholder's profit twice: once to the corporation when it sells the property and once to the shareholder when he sells the stock. There is no reason to tax it a *third* time as a dividend.

"The taxpayer was a corporation with an authorized capital of $260,000, none of which had been issued. In December, 1925, it issued $250,000 of its shares to one, Kuttroff, in exchange for land in New York which at the time was worth that amount, and which it sold in 1926 *at a small loss*. This it deducted in its return for that year, but the Commissioner struck out the deduction, and in its place assessed as a deficiency, a tax levied upon the difference between the proceeds of the sale in 1926 and the value of the land on March 1, 1913, Kuttroff having bought before that date.

* * * * * *

"The exchange took place after the Revenue Act of 1924 had *thrown upon the company the tax* on *Kuttroff's income*; it was a consequence with notice of which the company was charged and which it could escape. The only possible objection is under the Fifth Amendment, on the notion that the tax takes property without due process of law; and it has indeed been sustained when the result was to affect transactions which took place before the tax was imposed (*Nicholas* v. *Coolidge*, 274 U. S. 531, 47 S. Ct. 710, 71 L. Ed. 1184, 52 A. L. R. 1081; *Blodgett* v. *Holden*, 275 U. S. 142, 48 S. Ct. 105, 72 L. Ed. 206). But, so far as we know, it never has been, when the tax impinges prospectively, for the root of the evil is the inability of the parties to count upon the burdens they assume." [Emphasis ours]

(c) "Corporate Cost" or "Transferor's Cost."

With respect to the particular issue involved in this case, namely, whether earnings and profits of a corporation should be based upon corporate cost or upon transferor's

cost, the Courts have been uniform in holding that corporate cost must be used. See the cases cited and discussed in Appendix III to this brief. Rarely has there been such uniformity upon a tax question. If this Court were to hold otherwise, it would have to overrule every case that has ever been decided on the point, including numerous decisions of the Tax Court upon a question of accounting. Cf. *Dobson* v. *Commissioner*, 320 U. S. 489.

There is not a single case holding that corporate earnings and profits are to be figured on transferor's cost in any proceeding arising under the Revenue Act of 1938 or any prior Act. Indeed, three Tax Court decisions, after the enactment of § 501 of the Second Revenue Act of 1940, refused so to hold with respect to taxpayers not affected by such section. (See Appendix III to this brief).

There is no support for the suggestions by the Commissioner in his brief that there was "a doubt" or a "doubtful" point (pp. 10, 15, 20), that the law was "unsettled" (pp. 12, 36), that there was a "single decision" (pp. 11, 32), and that there was "no basis" (pp. 12, 34) for the rule relied on by the respondents in determining that the Company had no earnings or profits.[8]

(3) THE 1938 ACT AS APPLICABLE TO THIS TRANSACTION WAS NOT AFFECTED BY THE TREASURY REGULATION (Art. 115-3).

The only reason which the Commissioner gives in his brief as justifying his position that corporate earnings and

[8] The Commissioner's brief appears to rely on the fact that some of the cases supporting the Respondents' position were decided after 1938. That there are a number of recent cases on the point is in the respondents' favor rather than otherwise, and may well assist this Court in its determination of what the rule was under the Revenue Act of 1938.

profits were not in 1938 to be based on corporate cost, is a provision of the Treasury Regulations, first included in article 115-1 of Treasury Regulations 86, promulgated under the Revenue Act of 1934, and repeated for the 1938 Act in Art. 115-3 of Treasury Regulations 101, which reads as follows:

> "Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section."

The Commissioner in his brief (pp. 22-23) complains that the cases which have held that corporate earnings and profits are to be based on corporate cost have either overlooked or disregarded the above regulation. The reason is obvious. It is patently inapplicable. It says nothing about the *basis* on which earnings and profits from the sale of property are to be determined.

As evidence of the inapplicability of the Regulation to the case under review, it should be noted that in a number of cases cited in Appendix III to this brief, the Commissioner did not even cite the regulation to the Court. He did not even refer to it in his deficiency letter in the instant case (R. 13).

The Regulation does not apply to all gains and losses. It applies only to gains and losses "within the purview of section 112". Such gains and losses are gains and losses which have been realized, but the recognition of which for income tax purposes has been postponed under § 112 until some later date.

The Company realized no gain "within the purview of section 112" either when it issued its stock for property or

when it sold that property for less than cost. The Treasury Regulation above-quoted is inapplicable to the instant case.

And as the Commissioner's brief correctly takes the position that § 501 "wrote into all the Revenue Acts the rule stated in the Regulations" (p. 22), if the Regulation be inapplicable, § 501 is equally inapplicable.

PART TWO.

THE 1940 ACT

The position taken by both Courts below was that the deficiency assessment was not supported by the 1938 Act. This was the same position assumed by the Commissioner in the deficiency letter and in making his second point in his brief before this Court. In other words, both Courts below, the Commissioner, in his deficiency letter and the Commissioner in his second point here, assume that the question arises under the 1940 Act. The problem arises under two headings: (1) application of the Act, and (2) constitutionality of the Act if applicable.

POINT II.

§ 501 OF THE SECOND REVENUE ACT OF 1940 IS INAPPLICABLE TO THE FACTS OF THIS CASE.

(a) This is true of its language.

This is the position taken by necessary implication by the petitioner himself in the first point of his brief, wherein he argues that § 501 of the 1940 Act was to the same effect as the 1938 Regulation.[9]

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[9]Petitioner says that by the 1940 Act "Congress wrote into all of the Revenue Acts the rules stated in the Regulations" (p. 22 of his brief).

We think that in this respect the petitioner is right, and is supported both by the language of the new Act and by the evidence of Congressional intent provided by the House and Senate Reports. The language of the material part of § 501 is this:

> "The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation * * * (2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain."

> "Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided."

The subject-matter is the manner of employment of *realized* gain in computing earnings and profits. That the section applies only to *realized* gains or losses is apparent from the use of that word four times, once in the first sentence, twice in the second sentence, and once in the third sentence. If, and only if, a gain or loss is *realized*, (1) that gain or loss for the purpose of determining earnings and profits will be

determined upon the "adjusted basis for determining *gain*", i.e., rather than the basis for determining loss, where that differs from the former (see the discussion in Appendix IV to this brief), and (2) that gain or loss shall be taken into earnings and profits at the later date when it is *recognized* in computing taxable income.

The word "realized" was not in the House version of § 501; it was inserted in the Senate. It must have been intended to have some meaning since it was used four times in three sentences.

The statute has nothing to do with the question as to *when* gain is realized. Realization remains a condition precedent to its application.

In the vast majority of cases, of course, the gain or loss is realized by the same party that originally acquired the property. Such realized gains and losses are not to be taken into earnings and profits until such later date as they are recognized.

This was, as the petitioner rightly argues, confirmatory of the Commissioner's earlier Regulation (Art. 115-3), that

> "Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section."

The problem characteristically arises when the taxpayer is not the corporation, but is one who receives a dividend from the corporation. He must then determine whether the corporation had realized any "gains or losses" recognition of which has been postponed. But this does not for one moment mean that either the 1938 Regulation or the 1940

Act constituted an enactment to the effect that gain which had not been realized was ever to be taken into earnings.

(b) The Congress evidenced no other intention.

The reports to both Houses of Congress stated that the rule which they intended to promulgate was a rule "applied by the Treasury under existing law" in which "taxpayers generally have concurred." There is here no ground for the suggestion that the Congress intended to reverse all the decided cases. (See Appendix III.)

The Ways and Means Committee stated that the rule applied by the Treasury under existing law is that "gain or losses which are *not* recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits" and that the theory which it wished to overrule was "the theory that gain or loss, even though *not* recognized in computing net income, nevertheless affects earnings and profits" (H. R. No. 2894, 76th Cong., 3d Sess., page 41). [Emphasis ours] As the Commissioner says in his brief (p. 30), the purpose of Section 501 was to ratify "the rule expressed in the Treasury Regulations".

As an example[10] of the type of decision which it wished to overrule, the Ways and Means Committee cited *Commissioner* v. *F. J. Young Corporation,* 103 F. (2d) 137 (C. C. A. 3d, 1939). That case involved a situation clearly within the scope of the Treasury Regulations and wholly

[10]The only other example given relates to depletion, not to income realized from a sale of property. As this Court has held, a corporation's income is realized pre-depletion. Depletion allowances are a matter of legislative grace. *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103.

unlike the instant case. In the *F. J. Young Corporation* case, the taxpayer corporation exchanged property which had cost it $36,000 for stock in another corporation worth $957,000. The taxpayer corporation realized $921,000 profit on the exchange (*Marr* v. *U. S.*, 268 U. S. 536, *supra*), none of which gain was *recognized* to it under § 112 since it was a tax-free exchange under that section. If it had not been for § 112, the realized gain would have been taxable income.

The *Young* case did not involve the question of whether the corporation's earnings should be based on corporate cost or transferors' cost; the two were the same, since the corporation whose earnings were being determined in the *Young* case was itself the transferor. The question in the case was as to the time when an admittedly realized gain should come into earnings and profits of the corporation—*i.e.*, whether when realized, or at the later date when recognized upon a subsequent sale of the stock. The Court held that the profit came into the earnings and profits of the transferor corporation at the time it was realized and was not postponed, for the purpose of computing earnings and profits, until the profit was recognized for income tax purposes. This is the type of case that is referred to by Mr. Paul in the quotation at pages 18 and 19 of the Commissioner's brief.

Neither the *Young* case, the Treasury Regulation, Mr. Paul nor the new statute had application to cases other than those in which a corporation *realized* a gain or loss.

The Congress indicated no wish to overrule the holding of *Commissioner* v. *W. S. Farish & Co.*, 104 F. (2d) 833 (C. C. A. 5th, 1939), and of the other cases cited in Appendix III to this brief, that earnings and profits on the

sale of property are to be determined on corporate cost rather than transferor's cost.

The only other case cited by the Congressional Committees was *Commissioner v. Sansome,* 60 F. (2d) 931 (C. C. A. 2d, 1932), cert. den. 287 U. S. 667 (cited by the Commissioner at p. 19 of his brief). There a corporation was reorganized in a tax-free reorganization into a new corporation with the same shareholders. At the time of the reorganization, the corporation had accumulated earnings and profits which were set up on the books of the reorganized corporation as "Surplus and undivided profits" (22 B. T. A. 1171, 1175). The question was whether such earnings and profits retained their status as earnings and profits of the reorganized corporation. The Court held that they did, holding that a tax-free reorganization was a transaction which did not "break the continuity of the corporate life."

In the case under review, however, the transferors were not corporations but individuals who could have no "earnings or profits" the status of which was to continue unchanged. There was no "corporate life" which could continue unbroken. Moreover, the Company had no "surplus and undivided profits." The Commissioner cannot argue here in favor of disregarding the corporate entity of the Company, since any tax to the shareholders upon the liquidation of a corporation is based solely and completely upon a regard for the corporate entity. If that be disregarded there could be no tax upon liquidation.

And the fact that the Company was required to pay income tax upon the sale of the property based upon the cost of such property to its transferors does not call § 501 into

play where it realized no gain.[11] The Commissioner has admitted that the gain or loss which enters into the computation of earnings and profits under § 501 is not the same as the gain or loss used in computing taxable income. In T. D. 5024, 1940-2 C. B. 110, 113, promulgated under § 501, it is stated:

> "The 'recognized' gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115(1) [section 501] as distinguished from the realized gain or loss used in computing net income."

That § 501 was intended to affect only realized but unrecognized gains or losses (and not recognized but unrealized gains or losses) is further supported by the wording of the subcommittee's original recommendation for legislation:

> "Earnings and profits.—Your subcommittee recommends that chapter 1 of the Internal Revenue Code be clarified in order that the unrecognized gain or loss upon the sale or exchange of property by a corporation not be reflected in its earnings or profits account. This rule is in accord with the previous practice adopted by taxpayers and the Bureau of Internal Revenue alike and set forth in the income-tax regulations." [Report of a subcommittee of the Committee on Ways and Means (76th Cong., 3d Sess.) on proposed excess-profits taxation and special amortization, dated August 8, 1940 (p. 14).]

[11] In fact, the payment of the additional income tax based on transferors' cost would actually have diminished the earnings and profits of the Company below what they would have been if its tax basis had been corporate cost. *Commissioner* v. *James*, 49 F. (2d) 707, *supra*.

A *non*-recognition provision cannot be applicable unless there is a realized gain or loss to be recognized at a later date.

In other words, the *F. J. Young Corporation* case had held that *realization* was all that was required to bring a gain into earnings. The Treasury Regulations and later § 501 *added* the requirement of *recognition*. They did not subtract the requirement of *realization*.

We have found no case, except the decision of the Tax Court below, which has held that § 501 is applicable to cases in which the corporation realized no gain upon the sale of its property. The Tax Court's opinion shows that it obviously did not give full consideration to the point, but devoted its energies to the question of unconstitutional retroactivity.

(c) And the decided cases have so applied the new section.

We have been able to find only two reported cases applying the provisions of § 501. Both confine § 501 to situations in which a gain or loss has been realized and the recognition of that realized gain or loss has been postponed under § 112. In other words, both decisions accord with the distinction we have urged in this brief.

In *Commissioner* v. *Shenandoah Co.*, 138 F. (2d) 792 (C. C. A. 5th, 1943), the taxpayer had realized in 1936 and 1937 certain profits from the installment sale of property. Such profits were, because of the provisions of § 44 of the Revenue Act of 1936, taken into taxable income in later years. The question was whether such concededly realized gains increased the earnings and profits of the corporation in their entirety or only to the extent that they

were used in computing taxable income for the years in question. The Commissioner took the position that under § 501, earnings and profits were the same as taxable income. The Court rejected that interpretation and held that corporate earnings were increased by the entire amount of the realized gain, stating at p. 794:

> "* * * All that Section 501 does, all that it was intended to do, is to limit usable earnings and profits from sales of property to that portion of the gain realized which is taxable, and there is nothing in it which restricts such usable profits to those gains only which are returned for taxation in the year of their realization. * * *"

§ 501 was thus confined to gains "within the purview of section 112" and was not extended to gains within the purview of § 44.

Another example of the proper application of § 501, is *Butter-Nut Baking Company*, 3 T. C. 423 (1944) in which the taxpayer realized a gain in 1938 from insurance proceeds with respect to property which had been destroyed by fire, the recognition of which gain was postponed under § 112(f) of the Revenue Act of 1938.

For the year 1941, in computing its excess profits tax, the taxpayer attempted to include in its accumulated earnings and profits as of the beginning of 1941 (for invested capital purposes) the amount of the gain which it had realized on receipt of the insurance proceeds, The Tax Court properly held that under § 501 the gain realized in 1938 could not enter into the computation of earnings and profits until it was recognized, saying, at pp. 426-7:

> "It thus becomes apparent that for the taxable year here at hand we have a statutory direction that

earnings and profits may be increased by gain only to the extent that such gain was recognized in the computation of net income, whereas under the law affecting the *National Grocer Co.* case [1 B. T. A. 688], if gains were merely *realized*, they could properly be included in the determination of invested capital. Inasmuch as the $13,049.16 was not recognizable gain to the petitioner in 1938, it may not be used as a part of petitioner's earnings and profits accumulated at the beginning of the taxable year, under section 718 of the Second Revenue Act of 1940. The respondent did not err in disallowing the amount in the computation of invested capital."

§ 501 has also been applied in two unreported District Court cases to the realized gain or loss on an intercorporate liquidation under § 112(b)(6). *Cranson* v. *U. S.* (D. C. Cal.) 44-1 U. S. T. C. paragraph 9113. *Shuman* v. *U. S.* (D. C. ~~Cal.) 44-~~1 U. S. T. C. paragraph 9143.

It is reasonable to provide (as § 501 does) that realized gains shall be taken into earnings when recognized. It is completely unreasonable to say that fictitious gains which have never been realized should be taken into earnings and profits at all.

(d) Other applications of § 501 by the Commissioner are consistent.

The Commissioner himself has interpreted § 501 very narrowly, even as applied to realized gains and losses, and has in his published rulings to date strictly confined the section to gains or losses realized in transactions where recognition is postponed under § 112. For instance, he ruled that § 501 was not applicable to the following classes

of losses which are not allowed to be used in computing net income: (1) wash sale losses disallowed under § 118; (2) capital losses not taken into account in computing taxable income under § 117 because of the loss limitation provisions; and (3) losses disallowed because of a sale to a shareholder of the corporation under § 24(b) (T. D. 5024, 1940-2 C. B. 110, 113).

And in this case, the Company's *realized* loss on the sale of its property for less than cost was not an unrecognized loss within the purview of § 112. The recognition of the realized loss was not postponed under § 112. The loss was not taken into account in computing the Company's net income since, under § 113(a)(8) the Company was compelled to use a low transferor's basis for income tax purposes. The mere fact that a loss on a sale is not allowed for income tax purposes does not mean that it does not reduce earnings and profits. For example, a sale at a loss prior to March 1, 1913 (although never allowed for income tax purposes) is still taken into account in computing accumulated earnings and profits. *Lynch* v. *Hornby*, 247 U. S. 339. See also the examples cited above.

POINT III.

IT IS A REASONABLE CONSTRUCTION OF THE 1940 ACT THAT IT IS PROSPECTIVE IN APPLICATION. THAT CONSTRUCTION SHOULD BE ADOPTED TO AVOID A GRAVE CONSTITUTIONAL QUESTION.

(1) THE CONSTITUTIONAL QUESTION IS A SERIOUS ONE.

There are two reasons why the 1940 Act, if construed to have retroactively imposed a tax upon this transaction.

would present an unusually grave constitutional issue. These are:

First, if the 1940 Act is retroactive at all, the Act is retroactive so as to amend *all* prior Revenue Acts. This is conceded. Accordingly, the Act would not merely go beyond the period recognized in *Welch* v. *Henry,* 305 U. S. 134,—"during the year of the session in which the statute is enacted, and in some instances during the year of the preceding session." 305 U. S. at p. 148,—but would attempt "to reach events so far in the past" as to present the question expressly left open at 305 U. S. 148, *supra.* Indeed, because it attempts to reach *all* past events, it goes to the maximum possible extent.

Accordingly, we suggest that this is the case in which, if the 1940 Act is to be considered applicable at all to the instant case, this Court will have to go to the length of holding what it has heretofore steadfastly refused to hold, viz., that under no circumstances can there be an unconstitutionally retroactive taxing act. So to hold, would be to say that the use of the phrase "permissive retroactivity" was unnecessary and unjustified, nay even misleading to the taxpaying community.

On that view, the opinion of Mr. Justice Holmes (concurred in by Mr. Justice Brandeis, Mr. Justice Sanford and the present Chief Justice) in *Blodgett* v. *Holden,* 275 U. S. 142, 147, the opinions of Mr. Justice Holmes and of Mr. Justice Brandeis (both concurred in also by the present Chief Justice) in *Untermyer* v. *Anderson,* 276 U. S. 440, 446, the dissenting opinion of Mr. Justice Roberts (concurred in by Mr. Justice Holmes, Mr. Justice Brandeis and the present Chief Justice) in *Coolidge* v. *Long,* 282 U. S. 582, 606, the *ground* of decision, recognized by Mr.

Justice Roberts for the Court, and *relied on* by Mr. Justice Brandeis, Mr. Justice Cardozo and the present Chief Justice, in *Helvering* v. *Helmholz*, 296 U. S. 93, as well as the opinion of the Court in *Welch* v. *Henry*, 305 U. S. 134, 148, *supra*, would all fall within the same condemnation.

It is of course open to this Court, when principle compels, to announce a fundamental change in the law, having the effect not merely of reversing prior decided cases, but of undermining the reasoning upon which those prior cases had at the time been criticized by the dissenting justices. *Erie Railroad Co.* v. *Tompkins*, 304 U. S. 64.

But in this case the same members of the Court who united in the various dissenting and concurring opinions have at least once actually *held* a tax law unconstitutional if retroactively applied. In *Helvering* v. *Helmholz*, 296 U. S. 93, the Court was unanimous that the Fifth Amendment applied to tax legislation. Mr. Justice Brandeis, Mr. Justice Cardozo and the present Chief Justice placed their concurrence upon the sole ground that retroactive application of the statute there under consideration would be unconstitutional. Their concurrence (at p. 98) was "on the ground last stated in the opinion," written for the Court by Mr. Justice Roberts:

> "Another and more serious objection to the application of Section 302(d) in the present instance is its retroactive operation. The transfer was complete at the time of the creation of the trust. There remained no interest in the grantor. She reserved no power in herself alone to revoke, to alter or to amend. Under the revenue act then in force the transfer was not taxable as intended to take effect in possession or in enjoyment at her death. *Reinecke* v. *Northern Trust Company*, 278 U. S. 339. If Section 302(d)

of the Act of 1926 could fairly be considered as intended to apply in the instant case its operation would violate the Fifth Amendment. *Nichols* v. *Coolidge*, 274 U. S. 531."

White v. *Poor*, 296 U. S. 98, decided on the same day as the *Helmholz* case, was to the same effect.[12]

The rule applicable to the present situation was forecast not only in concurring and dissenting opinions, but in a recent opinion of the Court, *Welch* v. *Henry*, 305 U. S. 134, 147:

> "In the cases in which this Court has held invalid the taxation of gifts made and completely vested before the enactment of the taxing statute, decision was rested on the ground that the nature or amount of the tax could not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event. *Nichols* v. *Coolidge*, 274 U. S. 531, 542; *Untermeyer* v. *Anderson*, 276 U. S. 440, 445 (citing *Blodgett* v. *Holden*, 275 U. S. 142, 147); *Coolidge* v. *Long*, 282 U. S. 582. Since, in each of these cases, the donor might freely have chosen to give or not to give, the taxation, after the choice was made, of a gift which he might well have refrained from making had he anticipated the tax, was thought to be so arbitrary and oppressive as to be a denial of due process. But there are other forms of taxation whose retroactive imposition cannot be said to be similarly offensive, because their incidence is not on the voluntary act of the taxpayer."

[12] The *Helmholz* and *Poor* cases were decided in 1935 shortly after the Law Review prediction (quoted in the Commissioner's brief at p. 45) that the doctrine of "arbitrary retroactivity" was "as dead as wager of law."

The instant case satisfies each of such requirements of arbitrary and oppressive retroactivity. The respondents could not reasonably have anticipated such a change in the statute as the Commissioner claims that § 501 effected; and they had made a voluntary election based upon the law in force in 1938.

Second, in this case, the taxpayers, at the time of the particular voluntary acts (deciding to liquidate the Company and electing to come under § 112(b)(7) instead of § 115(c)) undertook them in contemplation of a statute expressly passed to inform them as to the nature and amount of the tax to be imposed upon the transaction, and which in effect invited the transaction.

Few sections of the revenue law have been more specific and limited in their application than that section of the Revenue Act of 1938 which provided the tax effect of a liquidation which

"occurs within the month of December 1938."

And it is stipulated that it was pursuant to the provisions of that Act that the Company was dissolved on December 2, 1938, and that the respondents filed their elections under the thereby newly enacted § 112(b)(7)(D).

(2) WHEN THE CONSTITUTIONAL QUESTION IS GRAVE, THE STATUTE SHOULD NOT BE CONSTRUED TO HAVE RETROACTIVE APPLICATION, UNLESS SUCH CONSTRUCTION IS COMPELLED BY ITS TERMS.

This doctrine, familiar and established in many branches of constitutional law, has had emphatic recognition in the field of revenue law.

Perhaps it was already forecast *sub silentio* when, in *Nichols* v. *Coolidge*, 274 U. S. 531, 543, Mr. Justice Holmes, Mr. Justice Brandeis, Mr. Justice Sanford and the present Chief Justice concurred in the result, but not in the opinion, in a case holding that a certain revenue enactment was unconstitutionally retroactive.

At the next term of Court, the doctrine found expression on behalf of the same four justices, in another case in which they concurred with a decision that a particular retroactive Revenue Act could not be applied to a transaction antedating its passage. The concurring opinion (of four Justices in an equally divided Court) was written by Mr. Justice Holmes, *Blodgett* v. *Holden*, 275 U. S. 142, 147-148:

> "Although research has shown and practice has established the futility of the charge that it was a usurpation when this Court undertook to declare an Act of Congress unconstitutional, I suppose that we all agree that to do so is the gravest and most delicate duty that this Court is called on to perform. Upon this among other considerations the rule is settled that as between two possible interpretations of a statute, by one of which it would be unconstitutional and by the other valid, our plain duty is to adopt that which will save the Act. Even to avoid a serious doubt the rule is the same. [citing cases]. Words have been strained more than they need to be strained here in order to avoid that doubt."

This has been the view adhered to in the subsequent cases mentioned under subdivision (1) of this Point.

We come now to the application of the principle to this particular statute, and suggest that although the Court may properly (at least in a case so extreme as this) be prepared,

in Mr. Justice Holmes' phrase, to "strain words" in order to avoid imputation to the Congress of an intent to have done a serious retroactive injustice, the statute in the present case is so phrased that no straining of words is necessary to reach the right result.

(3) THE STATUTE IS REASONABLY OPEN TO THE CONSTRUCTION THAT IT WAS INTENDED TO BE PROSPECTIVE IN APPLICATION, EXCEPT THAT IT WAS TO APPLY TO THE FULL YEAR DURING WHICH ENACTED (1940) AND THE PRIOR YEAR (1939). INDEED, THIS IS THE TRUE CONSTRUCTION.

The relevant portions of the new section—§ 501 of the Second Revenue Act of 1940, 54 Stat. 974, are the following:

TITLE V—AMENDMENTS TO INTERNAL REVENUE CODE

"SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

"(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

* * * *

"(b) *Effective date of amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

"(c) *Under prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the

> date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any Court of the United States."

It will be apparent that Congress made a distinction between the application of the new section to the Internal Revenue Code (adopted in 1939) and its application to prior acts.

It is significant that § 501 is the first section of Title V of the Second Revenue Act of 1940, which is called "AMENDMENTS TO INTERNAL REVENUE CODE". This is convincing evidence that the only statute intended to be amended by § 501 was the Internal Revenue Code, which is effective only for the taxable years 1939 and later years.

As to the Code, it said in subsection (a) that the Code "is amended", and that the amendment is effected "by inserting" certain specific new subsections.

As to the Code, there is added the succinct subsection (b) entitled: "Effective date of amendment", in which it is expressly stated that the amendment "shall be applicable" to taxable years after December 31, 1938.

The subsection (c) relating to prior acts, contains neither of these expressions. It is stated neither that "they are amended", nor that an amendment "shall be applicable" to the years governed by them. Within this subsection (c) there is indeed further expressed recognition that the section is an amendment to the Code rather than to the acts prior to the Code, for the amendments are described as

> "amendments made to the Internal Revenue Code by subsection (a) of this section.".

The function of subsection (c) next appears as one of stating the manner in which such amendments (to the Code) are to be "effective" *in respect of* the prior Acts. This effectiveness is to be "as if" they were a part of each such Revenue Act on the date of its enactment. In other words, they are not "to be" a part of such Revenue Act, but are "to be effective as if" they were a part of such Revenue Act; and "they" are "the amendments to the *Internal Revenue Code.*"

The function of subsection (c) was thus to determine the status of earnings and profits accumulated in 1938 and prior years (*i.e.,* years when the Revenue Act of 1938 and prior acts were controlling). This was to prevent any argument that the status of earnings and profits realized in 1938 and prior years was to be frozen (*i.e.* their status determined under the Act in effect when they were realized) and that only earnings and profits realized under the Code were to be determined by the new rule. As the Finance Committee said, § 501(c) was intended to effect "the application of a uniform rule *for the determination of the earnings and profits of all corporations* for all prior taxable years." [Emphasis ours] The Commissioner's brief (p. 28) omits the italicized portion of the quotation.

In *Butter-Nut Baking Company,* 3 T. C. 423 (1944), the amount which the taxpayer wished to include in accumulated earnings and profits as of 1941, had been realized in 1938, and under the law then in force had already become a part of earnings. If it had not been for § 501(c) applying the rule of § 501 to all past earnings whenever realized, the Court might have felt bound to determine their status as earnings by the law in force when they were realized. *Cf.* § 501(a) which uses the expression "under the law ap-

plicable to the year in which such sale or disposition was made."

The Commissioner's brief (pp. 26, 27) cites various sections of the Revenue Act of 1942, all, so far as relevant, relating to adjustments in taxable income, for the proposition that since the language used in such sections is similar to that used in § 501, the latter section must have been intended to affect income tax liability for all prior revenue acts. The Commissioner overlooks the fact that § 501 does not deal with adjustments to taxable income as such, but only with earnings and profits, which, as such, are not taxable but may affect tax liability of shareholders not only in the year they are realized but in later years as well.

If § 501 had been intended to affect *tax liability* for all past years, it would have been easy to say so. Cf., for example, the wording of the following retroactive provisions which specifically amend prior acts: § 213(f), (g), (h) and (i) of the Revenue Act of 1939; and §§ 137 and 186(a) of the Revenue Act of 1942. See also §§ 121, 122 and 127 of the Revenue Act of 1943 in which it is stated that provisions "having the effect of the amendments made" to the Internal Revenue Code "shall be deemed to be included in the revenue laws respectively applicable to taxable years beginning after" a particular date.

The retroactivity provision of § 137 of the Revenue Act of 1942 is particularly interesting when it is compared with the provisions of § 501(c) of the Second Revenue Act of 1940, set out *supra*. § 137(b) reads as follows:

> "(b) Retroactive Effect.—For the purposes of the Internal Revenue Code and the Revenue Acts of 1928, 1932, 1934, 1936 and 1938, the amendments made to the Internal Revenue Code and those Acts

> by subsection (a) of this section shall be effective as if they were a part of the Internal Revenue Code and such revenue Acts on the respective dates of their enactment."

There prior Acts as well as the Internal Revenue Code are expressly amended.

We suggest that there is here (1) not merely no need to strain words in order to reach the construction necessary to avoid the constitutional question, and indeed (2) more than sufficient to meet the test of reasonably possible interpretation required in the opinions of Justices Holmes, Brandeis and the present Chief Justice, but that there is indeed (3) sufficient to indicate that it would be plain *error* to construe the statute retroactively.

Nor is this view changed by the addition, made while the statute (after enactment in the House) was being considered in the Senate and which appears in its last sentence, to the effect that "nothing in this subsection shall affect" liabilities of taxpayers in litigation on September 20, 1940. This has ample scope to protect taxpayers in respect of the years 1939 and 1940 (in the latter case prior to the enactment of the statute). The status of earnings realized in 1938 and prior years could and does affect *tax liability* for 1939 and later years. There is no need to throw its application back to *tax liability* under the 1938 and prior Acts. Even if there were, its presence in the statute could easily be ascribed to an intention by the Senate *ex majore cautela* to protect taxpayers from injustice.

To convert such a sentence into one evidentiary of an intention on the part of the Senate to insure that injustice be done to taxpayers all the way back for as many years as the revenue authorities could show that actual litigation

had not yet commenced, as the petitioner asks this Court to do (his brief, pp. 25-29), would be, we respectfully submit, an undue exercise of zeal in the collection of taxes. It would ascribe motives to Congress which this Court would be slow to impute. And the Treasury is entitled to the same consideration. The present Secretary of the Treasury had testified before the Ways and Means Committee at the time it was considering the Revenue Bill of 1934:

> "As a matter of public policy the Treasury believes that it is inadvisable to attempt to go back into past years and now, in effect, tax what was not taxable then." [Statement of the Acting Secretary of the Treasury regarding the preliminary report of a subcommittee of the Committee on Ways and Means (December, 1933) p. 17.]

Nor would any particular purpose be served by making the statute of unlimited retroactivity for the purpose of tax liability. So far as tax collections for most years prior to 1939 were concerned, they would fall fortuitously upon taxpayers who were unlucky enough not to be protected by the statute of limitations or unfortunate enough (as in the instant case) not to have begun litigation by September 20, 1940. Certainly a ten year retroactivity would have caught all such taxpayers. However, unlimited retroactivity *was* needed in order to prevent the status of earnings and profits realized in prior years from being frozen under the provisions of such prior Acts, thus affecting tax liability for the year 1939 and later years. Many corporations had been in existence as far back as 1913, and it was accordingly necessary to have a uniform rule "for the determination of the earnings and profits of all corporations for all prior taxable years."

(4) THE REVENUE ACT OF 1938 HAD ALREADY BEEN REPEALED WHEN THE SECOND REVENUE ACT OF 1940 WAS ENACTED.

The Revenue Act of 1938 had been repealed effective February 11, 1939, by § 4(a) of the Internal Revenue Code Enabling Act (Public Act No. 1, 76th Cong., 1st Sess.), 53 Stat. Part 1. All the rights accruing or accrued at that time had been continued in effect, including the right of the respondents here to compute their taxes under the provisions of the 1938 Act existing prior to its repeal. § 4(b). Unless the 1938 Act were expressly stated to be *amended*, no amendment affecting tax liability thereunder should be deemed to be made by § 501. The Court below said (R. 129):

> "It is impossible to amend a law that no longer exists."

POINT IV.

IF THE 1940 ACT IS RETROACTIVE WITHOUT LIMITATATION, IT IS UNCONSTITUTIONAL.

If we must face the issue that was faced by both the Courts below, then we submit that the Circuit Court of Appeals for the Ninth Circuit rather than the Tax Court reached the right conclusion.[18]

In Point III we have indicated the unlimited sweep of retroactivity (to *all* prior Revenue Acts) and the unusually cruel incidents of its application to a taxpayer who had

[18] The decision of the Tax Court was by a single judge (Judge Arnold), and being on a constitutional question, was of course a decision of pure law.

framed his transaction in accordance with the precise Congressional invitation in the 1938 Act, now assumed to have been retroactively amended.

As shown in the statement of facts: (1) There is no evidence and no finding that the transaction would have occurred except for the Congressional invitation. (2) There is no evidence and no finding that the taxpayers in fact needed to liquidate their corporation for fear of the effect of legislation against so-called personal holding companies or of penalties thereunder. (3) It affirmatively appears that they had been paying in dividends the full amount of the corporation's income. (4) Had they liquidated under the usual statute, § 115(c), they would have paid at the 15% capital gains rate, and in the aggregate would have paid a lower tax and had a higher tax basis than they have after electing to come under § 112(b)(7), if we assume that the 1940 amendment changes the 1938 Act.

Therefore, assuming that Congress intended to, and did, retroactively amend its 1938 invitation, it not merely withdrew a privilege, but it tricked these taxpayers into paying a higher tax—not merely higher than was payable in 1938 under § 112(b)(7) but higher than if they had elected to liquidate in the usual way under § 115(c). We submit that neither in the statute itself, nor in the reports of the House and the Senate (which have been made available as appendices to the petitioner's brief), nor indeed in our general knowledge of the concern for common fairness which the Congress shows in the enactment of its revenue laws and which this Court invariably accords to Congress on principle, is there any justification for imputing to Congress the ingenious twist of the thumb-screw which the

petitioner has evolved from his misinterpretation of § 501 in this case.

But if we are wrong in all this, we submit that the only consequence must be that the time, long deferred, has now finally arrived at which this Court must hold an income tax act unconstitutional as in violation of the Fifth Amendment.

The Commissioner has purported to find some support for his views in three recent cases in various Circuit Courts of Appeals. Those cases are distinguished in Appendix V to this brief. For further review of the decided cases, we respectfully refer the Court to the opinion of Circuit Judge Garrecht for the 9th Circuit Court of Appeals, 143 F. (2d) 162 (R. 121-130).

CONCLUSION.

THE JUDGMENT OF THE CIRCUIT COURT OF APPEALS SHOULD BE AFFIRMED.

Respectfully submitted,

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January 25, 1945.

APPENDIX I

Sections 113(a)(6), and 117(a), (b) and (c). Relevant Provisions of the Revenue Act of 1938 (in addition to those set forth in Appendix A of the Commissioner's brief)

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—

* * *

(6) Tax-free Exchanges Generally.—If the property was acquired, after February 28, 1913, upon an exchange described in section 112(b) to (e), inclusive, the basis (except as provided in paragraph (15), (17), or (18) of this subsection) shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it."

"SEC. 117. CAPITAL GAINS AND LOSSES.

(a) Definitions.—As used in this title—

(1). Capital Assets.—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1);

(2) Short-Term Capital Gain.—The term 'short-term capital gain' means gain from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such gain is taken into account in computing net income;

(3) Short-Term Capital Loss. The term 'short-term capital loss' means loss from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such loss is taken into account in computing net income;

(4) Long-Term Capital Gain.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

(5) Long-Term Capital Loss.—The term "long-term capital loss' means loss from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such loss is taken into account in computing net income;

(6) Net Short-Term Capital Gain.—The term 'net short-term capital gain' means the excess of short-term capital gains for the taxable year over the sum of (A) short-term capital losses for the taxable years, plus (B) the

net short-term capital loss of the preceding taxable year, to the extent brought forward to the taxable year under subsection (e);

(7) Net Short-Term Capital Loss.—The term 'net short-term capital loss' means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year;

(8) Net Long-Term Capital Gain.—The term 'net long-term capital gain' means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year;

(9) Net Long-Term Capital Loss.—The term 'net long-term capital loss' means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

(b) Percentage taken into account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

(c) Alternative taxes.—

(1) In Case of Net Long-Term Capital Gain.—If for any taxable year a taxpayer (other than a corporation) derives a net long-term capital gain, there shall be levied, collected, and paid, in lieu of the tax imposed by sections

11 and 12, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of the net long-term capital gain, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 30 per centum of the net long-term capital gain."

APPENDIX II

Discussion of Cases and Rulings Showing that "Earnings and Profits" Differs from Taxable Income

"Earnings and profits" of a corporation clearly does not mean the same thing as "taxable income". The Treasury Regulations themselves admit this and provide that (1) all income exempted by statute from tax and (2) all income not taxable under the Constitution of the United States, although not included in taxable income, are included in "earnings and profits". Discovery and percentage depletion, although they reduce taxable income, do not reduce earnings and profits. Treasury Regulations 101, article 115-3.

The differences between taxable income and earnings and profits are many and have been set forth in a great many cases and rulings.

(1) *Examples Where "Earnings and Profits" Are More Than Taxable Income.*

The classic example of the clear distinction between taxable income and earnings and profits is contained in the decision of this Court in *Lynch* v. *Hornby*, 247 U. S. 339. In that case a corporation had large earnings and profits which had accrued prior to March 1, 1913, the effective date of the first income tax act. It was clear that those earnings and profits did not constitute taxable income to the corporation, but nevertheless, the Supreme Court held that they did constitute earnings and profits of the corporation so that any distribution from them would be a taxable dividend to the shareholders. That rule was more recently affirmed in *Helvering* v. *Canfield*, 291 U. S. 163, 167.

Dividends received by a corporation, although not included in taxable income under revenue acts prior to the Revenue Act of 1936, are nevertheless included in earnings and profits. The Commissioner has so ruled in the instant case, since he has included in the Company's earnings and profits $203,085.19 of dividends which were not includible in its taxable income from 1926 to 1935 (R. 17, 18).

Similarly, a statutory net loss may be carried forward for the purpose of computing taxable income, but not for the purpose of computing earnings or profits of the year available for dividends. *R. M. Weyerhaeuser*, 33 B. T. A. 594 (1935).

The proceeds of an insurance policy are not taxable income, but they have been stated to be earnings and profits which are available for dividends. *Cummings* v. *Commissioner*, 73 F. (2d) 477 (C. C. A. 1st, 1934).

Moreover, on a tax-free merger under § 112, the accumulated earnings and profits of the merged corporation become earnings and profits of the continuing corporation, although they are obviously not taxable income to the continuing corporation. *Commissioner* v. *Sansome*, 60 F. (2d) 931 (C. C. A. 2d, 1932).

(2) *Examples Where "Earnings and Profits" Are Less Than Taxable Income.*

In those years in which the net capital losses of a corporation allowable for income tax purposes could not be in excess of $2,000, a corporation with an ordinary income of a million dollars and a million dollar capital loss would have $998,000 of taxable net income under § 22(a), but would have no earnings and profits. This rule has been followed uniformly by the Treasury (see I. T. 3253, 1939-1 C. B. 178 and § 115-12 of Treasury Regulations 111 issued under § 501 of the Second Revenue Act of 1940). The Commissioner has applied that rule in the instant case to decrease the Company's earnings by $27,553.18 included in computing taxable income (R. 18). To the same effect are *Inland Investors, Inc.*, 44 B. T. A. 654 (1941), reversed on another issue, 132 F. (2d) 543 (C. C. A. 6th, 1942); and *Saxon Trading Corporation*, 45 B. T. A. 16 (1941). The rule has been held to be the same under § 501 (T. D. 5024, 1940-2 C. B. 110, 113).

A loss on a sale made by a corporation to a shareholder which is disallowed for income tax purposes under § 24(b) nevertheless reduces earnings and profits. The rule is the same under § 501 (T. D. 5024, 1940-2 C. B. 110, 113).

So also a wash sale loss under § 118, although not taken into account in computing taxable income, does reduce earnings and profits. The rule was the same under § 501 (T. D. 5024, 1940-2 C. B. 110, 113), until the specific amendment to § 501 made by § 146(a) of the Revenue Act of 1942.

Federal income taxes, although not deductible in computing taxable income, are deductible in computing earnings and profits. *Commissioner* v. *James*, 49 F. (2d) 707 (C. C. A. 2d, 1931). The Tax Court applied that rule in the instant case (R. 81).

So also, prior to the Revenue Act of 1936, an operating deficit from a prior year could reduce earnings and profits in a subsequent year. *Arthur C. Stifel*, 29 B. T. A. 1145 (1934). It could not, however, reduce taxable income.

Again, extraordinary expenditures and charitable contributions reduce the earnings and profits of a company. Such expenditures do not, however, reduce the corporation's taxable income. *Welch* v. *Helvering*, 290 U. S. 111; *Old Mission Co.* v. *Helvering*, 293 U. S. 289, 294.

Moreover, income realized on an installment sale of property, although not taken into taxable income in the year of realization, under § 44 of the Revenue Act of 1936, nevertheless is wholly taken into earnings and profits in that year. *Commissioner* v. *Shenandoah Co.*, 138 F. (2d) 792 (C. C. A. 5th, 1943). The rule has been held to be the same under § 501.

So far as we know, § 501 has not been construed to change the rule of any of the above cases.

Prior to § 501, an *unrecognized* gain or loss was taken into earnings and profits at the time it was realized. *Commissioner* v. *F. J. Young Corporation*, 103 F. (2d) 137 (C. C. A. 3d). § 501 changed that rule. However, no case had ever held that an unrealized gain or loss was taken into earnings at all. As the above cases show, only *realized* gains and losses affect the earnings and profits. Accordingly, § 501 which deals only with realized gains and losses, could have no application to the doctrines laid down in the cases cited in Appendix II and Appendix III to this brief.

APPENDIX III

Cases holding that a corporation's "earnings and profits" are based on corporate cost and not on transferor's cost.

By 1938, the rule that corporate earnings and profits derived from the sale of property were based on corporate cost and not upon transferor's cost was well settled; and the Commissioner relied upon it.

In *W. & K. Holding Corporation*, 38 B. T. A. 830 (1938), decided a month or two before the liquidation of the Company in the instant case, the Tax Court was presented with the problem of whether corporate earnings and profits should be based upon corporate cost or transferor's cost. The Government claimed that corporate cost should control. In holding that corporate cost (which, in that case, was lower than transferor's cost) should control, the Tax Court said, at p. 841:

> "Earnings available for dividends are computed upon actual gains and losses of the corporation as of the date of the distribution."

The case involved § 115 of the Revenue Act of 1932.

Early in 1938, the Tax Court had decided *W. S. Farish & Co.*, 38 B. T. A. 150, in which the taxpayer had taken the position that corporate earnings and profits were to be determined on corporate cost rather than on transferor's cost. In that case the transferor's cost was less than corporate cost. The Tax Court had again held that corporate earnings should be based on corporate cost, saying at p. 158:

> "The cost to a corporation of property exchanged for its capital stock is the fair market value of the stock so exchanged, and where there is no other method of determining the value of the stock, its value is held to be the fair market value of the prop-

> erty exchanged therefor. *Ida I. McKinney*, [32 B. T. A. 450, aff'd 87 F. (2d) 811 (C. C. A. 10th, 1937)] *supra*; *Reliance Investment Co.*, 22 B. T. A. 1287; *Mead Realty Co.*, 21 B. T. A. 1062; *L. H. Philo Corporation*, 16 B. T. A. 130; *Realty Sales Co.*, 10 B. T. A. 1217.
>
> "The cost to petitioner of the securities acquired in exchange for its capital stock was not less than \$1,118,084.65, the cost entered on its books. If petitioner thereafter had sold such securities for \$1,118,084.65, it would neither have derived a gain nor sustained a loss in fact, and its paid-in capital would have remained the same in amount, the form merely being changed from an investment in securities to cash. Under the statute it would have realized taxable gain in the amount of \$409,617.96, or the difference between the transferors' cost and the sales price, because it acquired the securities in a tax-free exchange. However, if petitioner has distributed such statutory *taxable income* to its stockholders, it would not have been a distribution out of 'gains and profits' but a liquidating dividend which, to that extent, would have invaded its paid-in capital."

The decision of the Tax Court was affirmed by the Circuit Court of Appeals for the Fifth Circuit in *Commissioner v. W. S. Farish & Co.*, 104 F. (2d) 833). The Commissioner filed no petition for certiorari.

The Tax Court approved the doctrine of the *Farish* case as applied to the Revenue Act of 1928 in *A. and J. Inc.*, 38 B. T. A. 1248, 1258 (1938).

The Tax Court has also approved the rule of the *Farish* case as applied to § 115 of the Revenue Act of 1934 in *Dorothy Whitney Elmhirst*, 41 B. T. A. 348 (1940). Although the *Elmhirst* case was decided about six years after the promulgation of the Treasury Regulation relied

upon by the Commissioner in the instant case, the Commissioner did not even cite the Regulation to the Tax Court. Since the Commissioner conceded in the *Elmhirst* case that the Tax Court had already decided, under revenue acts prior to the 1934 Act, that corporate cost and not transferor's cost should control in the computation of earnings and profits, if the Commissioner had at that time considered the Treasury Regulation promulgated under the 1934 Act as relevant, he would certainly have cited it to the Tax Court.

Since the passage of § 501 in 1940, the Tax Court has reaffirmed the holdings of the above cases in at least three instances:

*Falkland Corporation** (CCH Dec. 12, 170-A) decided November 8, 1941, affirmed on stipulation by C. C. A. 2d (January 15, 1943) 44-1 U. S. T. C. Par. 9271, involving the Revenue Act of 1936 (corporate cost lower than transferor's cost).

Senior Investment Corporation, 2 T. C. 124, 139 (1943)** involving the Revenue Act of 1936 (corporate cost higher than transferor's cost).

Estate of Fred J. Fisher† (CCH Dec. 13, 734M), decided February 9, 1944 (corporate cost higher than transferor's cost), involving the Revenue Act of 1934.

In the *Falkland Corporation* case, *supra,* the Tax Court pointed out that in the *Elmhirst* case the Commissioner had not relied on the Treasury Regulation. The Tax Court

*Memorandum opinion (not officially reported).

**The dictum in the case with respect to the effect of § 501 of the Second Revenue Act of 1940, as applied to cases not pending on September 20, 1940, is, we believe, both ill-considered and erroneous. The case cites the Tax Court opinion of the instant case in support of its conclusion. In the *Senior Investment* case and the other two cases above cited the petition in the Tax Court happened to have been filed shortly prior to September 20, 1940 and § 501 was in terms inapplicable.

†Memorandum opinion (not officially reported).

refused to decide that the Treasury Regulation was applicable, and said that in any event it was "not effective to overcome the decisions". The decisions "interpreted the statute, not the regulation". As the Commissioner said in his brief in the Circuit Court of Appeals in the *Falkland Corporation* case (p. 11), the Tax Court "sustained the taxpayer's contentions (1) that an amendment of the statute and not a mere Treasury regulation was required to change the effect of law laid down by the Board and the courts, and (2) that the regulation was not in fact applicable here, since it involved a gain or loss realized, and the taxpayer had realized no gain or loss when it acquired in 1932 the stock which it sold in the taxable year, but merely made a purchase of such stock."

It is thus apparent that the rule has always been that earnings and profits of a corporation have been determined by using corporate cost rather than transferor's cost. The rule can work either for or against the taxability of a shareholder upon a distribution, and, where the rule was in his favor, the Commissioner has applied it. The rule as so laid down by the decisions is both logical and sound. There is no indication that the Congress intended to change it by § 501.

APPENDIX IV

True Purpose of §501(a)

§ 501(a) had two main purposes, both of which related only to realized gains or losses and the manner in which such realized gains or losses were to be reflected in earnings and profits.

The first purpose was to make clear that in the case of a realized gain or loss, earnings and profits were to be determined by using the adjusted basis "for determining gain", i.e., rather than the basis for determining loss, where that differed from the former. The report of the Senate Committee on Finance (Report No. 2114. 76th Cong., 3d Sess., p. 23) shows that the purpose of this provision was to prevent earnings and profits from necessarily corresponding to taxable income rather than to insure that earnings and profits should conform to taxable income. Indeed, the only example given with respect to the operation of this provision is an example where the taxable income was zero but earnings and profits were nevertheless decreased.*

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*The Committee Report states: "The subsection provides that the gain or loss realized from the sale or other disposition (after February 28, 1913) of property shall, for the purpose of computing the earnings and profits (for any period beginning after February 28, 1913), be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain. For example, stock in the X corporation was acquired by the Y corporation prior to March 1, 1913, at a cost of $90, its March 1, 1913, value was $120, and in 1939 it was sold for $100. The basis (under the law applicable to the year 1939) for determining gain is the cost or, March 1, 1913, value, whichever is higher. As the Y corporation received $100 for the stock of the X corporation, and its value on March 1, 1913, $120, exceeded its cost, $90 (assuming that there are no adjustments to be made to the basis), the Y corporation realized a loss under the pro-

The second purpose of § 501(a) was to establish the rule that *realized* gains and losses, the recognition of which is postponed, are taken into earnings and profits only at the time and to the extent that they later become recognized gains or losses. That has been discussed at length in the body of this brief.

As further indication that the section was not intended generally to conform earnings and profits to taxable income, the third sentence provides that where "in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease [in earnings and profits] above provided." As stated in the report of the Committee on Ways and Means (Report No. 2894, 76th Cong., 3d Sess., p. 43) § 501(a), while "prescribing rules for certain cases * * * contemplates that consistently with these rules the computation [of earnings and profits] shall be made conformably to the best accounting practice". There can be no doubt that under the best accounting practice corporations' earnings on the sale of property are computed on the basis of corporate cost and not on the basis of transferor's cost.

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visions of this subsection of $20. If such a loss is recognized under section 112, the decrease in the earnings and profits accumulated by the Y corporation after February 28, 1913, as the result of this transaction in 1939 was $20 notwithstanding provisions of the code to the effect that no deduction was allowable in computing net income."

APPENDIX V

Recent cases in the Circuit Courts of Appeals relied upon by the Commissioner on the issue of constitutional retroactivity.

The Commissioner's brief (p. 44) cites in favor of his position three recent Circuit Court of Appeals cases involving § 213(f) of the Revenue Act of 1939. *Wilgard Realty Co. v. Commisioner*, 127 F. (2d) 514 (C. C. A. 2d, 1942), cert. den. 317 U. S. 655; *Commissioner v. Corpus Christi Terminal Co.*, 126 F. (2d) 898 (C. C. A. 5th, 1942); and *D. W. Klein Co. v. Commissioner*, 123 F. (2d) 871 (C. C. A. 7th, 1941), cert. den. 315 U. S. 819. Under the principles declared in *U. S. v. Hendler*, 303 U. S. 564, it appeared that the transactions in the above cases, which had taken place in 1931 and 1932, would not have been tax-free reorganizations, but that, under § 213(f) of the 1939 Act, which was expressly made retroactive, the transactions were tax-free reorganizations.

The opinions in the *Corpus Christi* and *Klein* cases do not show that the taxpayer raised any issue under the Fifth Amendment. In the later *Wilgard Realty* case, the court was careful to note that the taxpayer believed when the exchange was made in 1932 that it was a "tax-free one" and that both the taxpayer and its controlling shareholder treated the exchange as a tax-free exchange. The Court said, at p. 517:

> "Obviously, the petitioner has done nothing it would not have done had the law been, when the exchange was made, exactly what the 1939 enactment later made it. It has, therefore, not been the victim of any injustice and until it can show that it has been hurt it may not challenge the constitutionality of the statute."

The above rule cannot be applied to the instant case. At the time the respondents elected to come under § 112(b)(7), they rightly thought that the tax would be less under that section than under § 115(c). If § 501 were construed as the Commissioner claims it should be and applied to the year 1938, it would cause the taxpayers to pay more tax under § 112(b)(7) and have a much lower basis for the property received on liquidation than they would have had if they had liquidated the Company under § 115(c).

The Commissioner (at pp. 34-37 of his brief) sets forth an ingenious but specious argument to the effect that, regardless of the proper interpretation of a statute, the Congress can always retroactively amend it until that statute has been construed in a final decision by this Court. We know of no cases supporting the Commissioner's position; and he has cited none. The possibilities of capriciousness which such a doctrine would create are almost unlimited. Most statutory provisions never require a decision by this Court. In any event, that argument is not applicable to the instant case, for as far back as 1925 this Court had defined the term "earnings or profits" to mean "undivided profits or surplus". *Edwards* v. *Douglas,* 269 U. S. 204, *supra.*